# THE WEAPONISATION OF THE DOLLAR

## POLICY OPTIONS FOR SMALL COUNTRIES

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SMALL COUNTRIES

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# INTRODUCTION

The decision by the Trump administration to withdraw from the Iran deal and to amplify its sanctions regime against Iran, in spite of an international agreement to provide Iran a pathway back to normalisation, has demonstrated three things: First, just how central the US is to the way the international economic and financial system operates; second, just how many policy tools can be deployed in pursuit of their agenda; and third, how US thinking on economic warfare—sometimes referred to as economic statecraft in more benign times—is staging a comeback as an active component in dealing with the wider world. This Strategic Update will look at a relatively unused and untested tool available uniquely to the US: the dollar as a currency, together with the infrastructure of the global payments system through which dollar-based transactions take place.

The blunt application of various restrictions on the use of the dollar and the global payments system in any dealings with Iran has raised fundamental questions for other countries; namely, how best to respond to the direct and indirect effects of this measure. Among smaller countries, the sense of vulnerability and alarm is further heightened by the inability of the EU, Japan, Russia and China to effectively circumvent this unilateral US action, or to provide an alternative to the dollar system. And if the feeling is that these countries will now have to fend for themselves and find their own coping mechanisms, then the global system could quickly fragment as countries move to protect themselves from a more general breakdown in a global system that has provided the institutional and operational architecture for global trade, investment, finance and payments on which everyone substantially depends.[1]

Sanctions on using the dollar have been leveraged in the past against Cuba, Russia, North Korea and others, but never with such wide effects. The case of North Korea most closely replicates that of Iran, but the scale of the impact is altogether different. North Korea is an isolated economy and not really connected in any meaningful way to the global economy.

The Iran case thus takes this practice to an entirely new level in several ways. As part of a unilateral US strategy to bring Iran into compliance with specific US demands—an action which runs counter to an existing and valid international agreement—it reflects a breakdown of the UN system. Furthermore, the term 'weaponisation' is also apt as it explains how a relatively neutral but essential facility—the dollar and its accompanying payment system—have been turned into a powerful weapon by one UN member state against another without appropriate sanctions in place. In addition to weaponisation, it also represents an aggressive form of extraterritoriality which has perhaps not been seen on this scale in the past, and was thought to have broadly disappeared in the post-war order.

Debates about the centrality of the US to the global system have been revived, and ideas about finding alternative approaches to coordinating global economic, financial and trade activity are engaging policy makers

## THE WIDER POLICY DEBATE

There are many wider issues engaging the attention of policy makers around the world beyond this single concern, centring mainly on escalating trade and currency tensions and a deteriorating strategic environment with fresh controls on international investment flows. This constantly shifting landscape makes it difficult to chart a path through increasingly apparent risks and challenges—more so for smaller countries that have a limited range of policy tools to deploy in response.[2]

At a systemic level, debates about the centrality of the US to the global system have been revived, and ideas about finding alternative approaches to coordinating global economic, financial and trade activity are engaging policy makers around the world. But as prospects of redesigning the entire global system—a process that would have to include the US—are inconceivable at the moment, the only option left is to consider national or regional policy measures that could limit exposure to whatever happens next.

Within the US the debate mirrors international concerns but from an altogether different perspective. The question for them is whether providing an international reserve currency is either sustainable or desirable. Here again there are two

perspectives, one stemming from the strategic leverage of providing this system (positive), to the economic cost of doing so (negative).[3]

This paper will focus on smaller countries, exploring some of the considerations they will have to incorporate into their analyses and looking at some of the assumptions they have to make. Their situation is difficult, to put it mildly. With global policy coordination in disarray they will need to depend on finding powerful friends, creating regional arrangements or building new models of self-sufficiency. None of these options are as productive—from an economic point of view—as the present arrangement. Politically this would give rise to new forms of dependency, creating the conditions for a revival of spheres of influence and big power rivalries, both of which are natural pre-conditions for future conflict.

## COUNTRIES IN FOCUS

The situation and perspective of each country is unique, so generalising about the lines of active thinking is of limited use when trying to identify national options. Nevertheless, the overall situation is instructive in terms of how policy responses could unfold and the wider effects that these national actions may have.

My focus will be on smaller economies, excluding most Organization for Economic Cooperation and Development (OECD) members and China, but including Mexico and Turkey. OECD members are excluded because they have currencies that are by and large fully convertible and freely tradable at market rates; and China because it needs to be considered in a category of its own.

Other large emerging economies are included because they are still relatively small in global terms, or vulnerable in other areas. Though obviously a very rough and imprecise measure, my idea is to consider countries that share one or more of the following:

- Are very heavily dependent on the dollar either because of trade (mainly in oil and minerals), investment, debt or currency management strategies;
- Do not have strength in depth in the financial services sector, and are barely present in global financial services markets;
- Still have currency controls, even if they have been planning to remove these as they integrate globally (but excluding China);
- Are very small, and dependent on trading or political relations to manage essentials of food and energy supplies in particular. Small, isolated island nations and poorly connected landlocked states often fall into this category.

Some countries belong to more than one of these categories, which reflects a more complex dependency not only on the dollar but on other critical relationships as well. All of these factors are likely to come into play assuming that the weaponisation of the dollar starts to cause growing levels of instability.

## ISSUES TO CONSIDER

To understand the parameters of this discussion, we also need to clarify how monetary policy differs from sanctions, and why it is that the sanctions process is the one that weaponises the dollar in the present situation, even as its effects flow through channels created by monetary policy.

In the US, monetary policy is set by the Federal Reserve, which acts on its congressional mandate for price stability and full employment. Price stability can mean three things: interest rates to contain inflation, money supply to keep supply and demand in balance, and exchange rate management to keep the international value of the dollar stable. None of these have been weaponised, though they have been used to stimulate economic activity (for example through interest rate reductions and quantitative easing), which can have significant (benign and harmful) spillover effects. It is hard to weaponise monetary policy in these circumstances, and the US Federal Reserve has not done so, though President Trump has made occasional references to weaponising international dollar values in the context of providing monetary policy backing to his trade wars with China and the EU.[4]

The monetary policy of other countries does not matter to the same extent, even where they have full convertibility. Compared to dollar usage, which accounts for more than 60 percent of global contracts, the footprint of other currencies in global markets is far more limited. The euro comes next at about 22–24 percent, with others (the yen, sterling, Swiss franc) all in single figures. Monetary policy is even more limited in its global impact in countries that do not have convertible currencies, or which manage with reference to the dollar. However, it is relevant where it relates to currency convertibility, setting international exchange rates and deciding on the currencies in which it prefers to hold reserves. One legacy of the Bretton Woods system of fixed exchange rates (1944–1971) is that most countries continued to trade, borrow, invest and operate in US dollars, and to use US financial institutions to do so.

Sanctions, on the other hand, provide authority to the executive to pursue a strategic objective. They criminalise or penalise anyone who uses the dollar, financial institutions with a legal presence in the US, or the international payments system (SWIFT), which is owned by a consortium of US banks. Sanctions in the Iranian situation include denial of access to the dollar system as a means of stifling investment, trade and international transfers. Sanctions also cover other international transactions, so a dollar sanction also needs to be understood in its broader context.

## DEVELOPING-COUNTRY PERSPECTIVES

Seen from the perspective of some developing countries, the global system has shifted significantly over the years away from reflecting their concerns and towards the interests of larger economies. With the Economic and Social Council (ECOSOC), the United Nations Development Programme (UNDP), and the Group of 77 (a coalition of 134 developing nations) never able to play their anticipated role in shaping the policy

agenda in the formative years of the UN system—nor in developing alternative economic models—control over the global economic agenda first shifted dramatically towards the IMF (in the aftermath of the debt crisis and then following the collapse of communism), and then towards the World Trade Organization (WTO) and the institutionalisation of market-based systems.

With the OECD providing the intellectual firepower to guide the overall process, the political leverage of the larger economies—mainly the G7—effectively forced their economic and political model on much (but not all) of the rest of the world. Still more potent groupings then emerged to deal with the financial crisis (the G20 and the Financial Stability Board). It is this loose grouping of like-minded nations that is now fragmenting in the aftermath of unilateral US actions.

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The model that created the basis for the extraordinary phase of globalisation from 1995 to 2016 incorporated the need for open investment regimes, trade liberalisation, currency convertibility and a globally integrated financial services sector into a unified package that had to be adopted as a whole, or at least in phases. It is this model, with its unpredictable distributive effects, that Trump is essentially dismantling in pursuit of a narrow mercantilist and strategic agenda.

## US MONETARY POLICY OVER TIME

Through all of these phases, the US Federal Reserve was very restrained in its currency and monetary management decisions, and was mindful of its global responsibility, even as it was constrained by its national mandate. In parallel with this, US administrations were also aware of the importance of preserving the credibility of the dollar by limiting its deployment as a weapon. While other countries sought to manage their currencies with reference to the dollar, especially after 1971 when the fixed exchange rate system collapsed, the Federal Reserve largely ignored these interventions, seeing them

as short-term ameliorative measures that were inevitable in the way the system had evolved since 1971. Moreover, they were too marginal to affect the value or status of the dollar, particularly as larger economies moved towards full currency convertibility, applying exchange rate management systems that were largely consistent with the US model.

One consequence of this arrangement was that the dollar was viewed not just as a market-determined reference point in its function as a store of value, but as a safe currency in which to hold and transact business. With growing economic and trade liberalisation, international institutions such as the IMF and the World Bank built policy advice around assumptions of a stable and dependable dollar system, with other reference currencies in the same basket. Indeed, the removal of capital and currency controls, especially from the 1990s onwards, were predicated on these assumptions remaining valid.

The conflict between domestic mandate requirements and international responsibilities did precipitate an economic crisis on occasion. Perhaps the most dramatic was when the Federal Reserve raised interest rates in 1982 (from 5.85 percent to 20 percent) to deal with domestic inflation, simultaneously altering the debt obligations of many countries that defined their debt in dollar terms, and precipitating a global debt crisis. One further case is worth mentioning: the 1985 Plaza Accord which involved coordinated action to push the value of the yen up against other major currencies. This was seen as a corrective rather than a punitive measure. Today, the Japanese might not agree with this view.[5]

Generally however, the Federal Reserve was aware of its wider obligations and sensitive to monetary decisions that could and did affect countries around the world. These concerns were often discussed and considered in established forums like the G20 or the Bank for International Settlements (BIS) and the Financial Stability Board. This spirit of cooperation was evident in the aftermath of the financial crisis in 2008 when the US used quantitative easing to stimulate economic activity, but actually altered the value and availability of the dollar in international markets, thus affecting investment flows. Nevertheless, and rather unsurprisingly, most developing countries started to take defensive measures to limit the impact of US monetary policy, particularly in the aftermath of the financial crisis. The events of 2013, which saw investments pulled out of emerging economies in anticipation of higher yields in dollar-denominated assets dramatised the wider effects of US monetary policy. Some of these measures remain in place and could prove significant in the event of the Iran (or indeed any other) crisis escalating sharply.

On occasion, it is IMF policy rather than US monetary policy that precipitates a reaction amongst policy makers in smaller countries. Asian economies that suffered heavily during the Asian financial crisis of 1997 –98 learnt an important lesson: high levels of dollar and international currency reserves were needed to insulate economies against shocks. While this made perfect sense, it

did increase the exposure of these countries (including China) to the dollar.[6]

Taken together, it became increasingly clear that smaller economies, while increasingly vulnerable to US monetary and dollar management practices, had actually taken some measures to insulate their economies from the effects of monetary policy. But no one really expected the dollar system to be weaponised, and no one has really prepared for it. At the same time, these countries found their status in the international system steadily weakened by the erosion in their diplomatic, political, strategic and economic clout.

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## UNDERSTANDING THE CENTRALITY OF THE DOLLAR TO THE GLOBAL ECONOMY

The post-war economic system was built around using the dollar and US capital to launch and support economic recovery. In return, the US had to commit to managing the dollar in accordance with its agreed responsibilities under the fixed exchange rate regime, while the rest of the (non-communist) world was to move increasingly towards an open trade and investment regime with full currency convertibility. Thus we talk about the Bretton Woods system, which was further strengthened and institutionalised with the collapse of communism, the creation of the WTO, the accession of China in 2001, and many countries moving towards currency convertibility.

Problems of excessive dependence on the dollar were recognised during the Bretton Woods negotiations, and subsequently in technical analyses that highlighted the complexity of managing a currency[7] that was used for both domestic and international purposes, especially as other countries failed to move towards full convertibility. The political leverage of a dollar-dependent world was also recognised, and critically characterised by Valery Giscard d'Estaing in 1974 as "an exorbitant privilege",

meaning the US could run trade and fiscal deficits virtually without limit, but of course with consequences.

So the potential to weaponise the dollar was often recognised, but the US very rarely moved decisively in that direction. Efforts to punish Cuba, isolate the Soviet Union and China, and starve communist regimes of funds were an integral part of Cold War strategy, but were designed as an alternative to armed conflict. Political and military relations were then managed to try and avoid war, in anticipation of ultimate economic collapse, which happened in the Soviet sphere, but not in China. The present strategy of weaponisation seems to be designed to provoke a war.

Today, about two-thirds of all dollars in circulation are outside the United States, with a similar proportion reflected in global trade and investment contract. Oil and mineral markets are almost wholly operated in dollars....

Although the fixed exchange rate system collapsed in 1971, the dollar continued to function as the world's reserve currency used preponderantly in areas of trade and investment, and used principally by multinational corporations in their global operations. At the same time, the global bond market—the largest driving force of global investment and growth—was dominated by dollar-denominated assets, the bulk of which flowed from US capital markets and US government debt.

Today, about two-thirds of all dollars in circulation are outside the United States, with a similar proportion reflected in global trade and investment contracts. Interestingly, oil and mineral markets are almost wholly operated in dollars, which leaves Iran (and many others) particularly vulnerable to dollar weaponisation.

None of the other main currencies comes close to the scale and scope of the dollar. The euro, yen, sterling and others collectively account for about 38 percent of global debt and global transactions, with the euro further constrained by the absence of a Europe-wide bond market.

In parallel with the use of the dollar in trade, investment, borrowing and contracts, a huge and complex financial architecture has developed around being able to provide this service. This mainly consists of global financial institutions, payment and interbank transfer systems (SWIFT), and internet-based companies (mainly based in the US), which are all either registered in the US or are heavily committed

to the US market and therefore unwilling to disengage to preserve a service for a relatively small economy (Iran).[8]

Briefly stated, therefore, countries or entities fall within the jurisdiction of US authorities if they:

- Use the dollar in transactions,
- Want to access the US bond or stock market,
- Use US-registered financial institutions of any sort as intermediaries,
- Use US interbank payment systems,
- Use US-based internet servers of IT facilities,
- If US-registered intellectual property is involved and licensed,
- If any US commercial entities are involved, or
- If US nationals are involved.

But the system of sanctions goes further. Violation also occurs if a third-party entity has a registered presence in the US or if their actions (as with Cuba) affect the interests or assets of US entities. The extent and nature of these violations would differ from sanction to sanction and are almost impossible to fully understand for any company operating globally.

Taken together, these conditions cover practically every trade transaction, investment measure, financial transfer, interstate relationship or corporate activity in the world. Circumvention without entering some form of US jurisdiction is almost impossible, which is why EU companies find it so difficult to trade with or invest in Iran. The US is central to the global financial services system in terms of the currency used, the financial institutions that conduct activities, and the technological platforms involved. The weaponisation of the dollar system can be hugely destructive to anyone directly targeted, and hugely damaging to everyone else.

A couple additional points need to be mentioned here. The first is that the legitimacy of international sanctions is supposed to flow from the UN, and not from unilateral actions. Indeed, the UN Charter makes a presumption of good relations as one of its main principles for membership. Good relations together with collective security imply that no individual state is to take the law into its own hands. This arrangement has clearly broken down.

The second point is that US sanctions in the case of Iran are in direct conflict with the Iran deal, which is an internationally recognised agreement and thus legally binding on all UN member states—even those not party to the agreement. This too represents a major breach in the international system. The problem is that the status of the US makes it impossible to rectify the situation.

## POLICY OPTIONS FOR DEVELOPING COUNTRIES

Although the weaponisation of the dollar is the culmination of a fairly long process, most countries seem to assume that it is an aberration and things will return to normal over time, especially given the inconsistency and unpredictability of US policy moves. But increasing trade friction between the US and China (whether actual

or rhetorical), tensions with Iran, Russia, North Korea, Cuba and Venezuela, and the simultaneous weaponisation of other policy instruments—investment rules, technology controls, etc.—tend to confirm that the US is arming itself for some sort of general showdown. Add in the current ambiguity in US relations with the EU, and the implications become more serious for other countries around the world, even if only indirectly. While the larger economies with big internal markets, convertible currencies and large dollar reserves will develop strategies to counter dollar weaponisation, it is smaller countries that need to think about their exposure to these risks.

One thing the Asian financial crisis and the 2008/9 financial crisis taught global policy makers is that there are multiple channels through which an economic crisis in one system engulfs a wider region and ultimately the global economy, while assuming various new forms along the way. These same channels could be the pathways down which dollar weaponisation transmits its wider effects. At the same time, there is no precedent for a reserve currency being weaponised in this way and on this scale, so the policy response may have to evolve through trial and error.

There are also no policy measures currently available to the IMF or other institutions to guide policy makers; on the contrary, these institutions have built-in assumptions that major convertible currencies—and the dollar in particular—would be managed with reference to stability concerns and not wielded as a weapon of war. Traditional methods of insulating economies against currency and trade risks, whether political or economic, will need to be extensively reviewed.

Beyond the nature of the response, there is the issue of the form that this will take. Do they work with like-minded countries and if so which are these? Do they use established combinations—like the G77—or established institutions to express their concerns in a quest for a solution? If the latter, they need to deal with a deep systemic reality: the US is central to all these institutions.

Many countries could find themselves in an exposed, isolated and helpless situation, hoping that nothing will happen and deeply unprepared—individually or through appeal to international institutions—if anything does. The available alternatives to relatively new institutions, such as the Asian Infrastructure Investment Bank (AIIB), carry other political risks, many of which are untested and difficult to assess,

Policy responses will likely come in five principal areas: monetary, fiscal, trade, investment and domestic economic management. Taken together, and if these policies are truly defensive in scope and application, we will be looking at the complete reversal of a process that has been in train since the end of the Second World War, namely global economic integration and interdependency.

We can get a sense of what could be involved in each policy area by looking at the assortment of policy measures that may be activated many of which were prevalent before the 1980s.

**Monetary**

- Diversification of reserves away from the dollar
- Stockpiling of gold, silver and aluminium in particular
- Reintroduction of capital and currency controls
- Currency swaps
- Active use of interest rates and monetary policy to stabilise and stimulate the economy

**Fiscal**

- Reduction in international borrowing and diversification away from dollar-denominated debt
- Expansionary fiscal policies to fill the gap in infrastructure spending, domestic consumption and growth requirements
- Higher taxes to pay for this

**Trade**

- Increasing indifference to WTO rules and their national application
- Quantitative restrictions on consumer goods
- Greater use of national security exemptions
- Deviations and exceptions to IP protections on national security and public health grounds
- Closing public procurement to international providers
- Greater use of regulatory autonomy to create national standards and systems
- Special privileges for domestic agriculture and the small to medium enterprise sector
- Limiting of global banks in the domestic economy
- Dismantling the domestic commitments to the Agreement on Trade-Related Investment Measures (TRIMS)
- Greater and more widespread use of subsidies in the domestic and export markets
- Export and import licenses

**Investment**

- Growing use of national security considerations in approving international investments and mergers and acquisitions
- Selective approach to preferred investors and the currency of investment
- Revival of technology transfer and local supplier conditions (TRIMS)
- Protection and state control of the commanding heights of the economy (strategic sectors)
- Promotion of state-owned enterprises

**Domestic policy management**

- Industrial, agricultural and services policy initiatives to create self-sufficiency
- Weakening of international IP protection on national interest/security grounds
- Immigration controls on professional and skilled workers
- Emigration controls and de-recognition of international qualifications and degrees

This list is illustrative, and not all countries will use all of these policies. However, this

will be the direction of travel if the current situation with Iran continues and the dollar is indeed weaponised—more so if the present impasse in US–China relations continues or if their relations deteriorate further.

## CONCLUSIONS

These measures will come at a huge cost. Apart from representing a complete reversal of global economic integration, it will lead to some or all of the following:

- Capital will be less abundant and more expensive, possibly leading to slower investment and growth in both the government and private sectors;
- Capital controls will need to be managed to satisfy balance of payments requirements;
- Trade contracts and trade currencies will carry higher risks and be more expensive to manage;
- The pool of skilled labour will diminish over time, possibly eroding productivity, while remittance flows could also diminish (if everyone does the same thing);
- Unless well managed, the process could lead to a disorderly restructuring of domestic economies, especially in sectors active in global markets. For some countries this will be in industrial and agricultural commodities and raw materials, while for others it may be in merchandise trade. For some it could be in both areas;
- Recourse to international institutional borrowing (from the IMF/World Bank) will become more difficult with the US possibly hostile to supporting bailouts and debt restructuring, so countries will need to build their reserves (as in much of Asia) and make sure they never run a deficit (as in the case of Taiwan).

Beyond these measures, which are likely to kick in through tentative steps and pass through various stages, debates will develop around new models for economic development which would resonate with the debates of the 1960s and 1970s. Also to be noted is that many economists and policy analysts think that globalisation has gone too far and that some or all of these measures are needed in any case to restore sanity to the way national economies are managed, and the priorities they pursue. This is a powerful view held within many developing countries—especially when considering the effects of globalisation on equality—and is increasingly commonly held by environmentalists and conservationists.[9]

As countries come to terms with a new reality, political relationships will be redefined. Strategic friendships will be sought in order to mitigate some of the risks, particularly for economies dependent on food or energy. This in turn will create a new pattern of interdependencies that will operate largely outside current global frameworks and will possibly develop rules, practices and procedures that are inconsistent with other international obligations. The WTO system, for example, would crumble completely in the face of this happening.

And within the US debates about the future of the dollar as a global reserve currency will only add to the uncertainty and perhaps

precipitate a larger crisis as old certainties give way to new fears.

All this just from the weaponisation of the dollar? Perhaps it is overstated, but if the effects on the Iranian economy start to impinge on the economic wellbeing of other countries, and affects their balance of payments, we will see the first stages of this scenario unfolding. Perhaps it will be with the reintroduction of capital and currency controls. ■

# NOTES

1 John Plender in his piece on Market Insight, "Mercantilist cat out of bag heralds new world order for financial assets", in the *Financial Times* of June 5th 2019, makes this point through an exploration of how markets are reacting.

2 *The Economist*, in its Leader on "Weapons of mass disruption", p.13, June 8th-14th 2019 summarises some of these broader concerns and implications.

3 James Politi, in his piece in the *Financial Times*, of 1st /2nd June 2019, "Fed nominee hits at bank's Soviet-style market power" (p.8 in the FT Weekend), explores this issue in his analysis of the views of Judy Shelton, currently the US representative on the board of the European Bank for Reconstruction and development (EBRD), and possible nominee for the US Federal Reserve Board of Governors.

4 Paul Krugman, "Trumpifying the Fed and our future", *The New York Times* (International edition), p.1, June 22-23rd, 2019, highlights the wider implications if this happens.

5 Sender, H., in the *Financial Times*, 17th June 2019, "The Weaponisation of the dollar risk rebounding on the US" reflects on the longer term effects of dollar weaponisation and the harm it could do to the US domestic economy as sanction measures actually play out.

6 Smith, J., "On China, Trump needs Europe", in *The New York Times* (International Edition), p.7, June 13th, 2019.

7 The Triffin Dilemma is often cited in this context, though JM Keynes foresaw much the same in broader terms. See Lebowitz, M., "Triffin Warned Us", in Realinvestment Advice.com, April 18th 2019, for more depth and detail.

8 Maharrey, M., *SWIFT and the Weaponization of the dolla*r, from the Foundation for Economic Education (FEE), 6th October 2018.

9 Andy Becket in the Long Read in the Guardian (25th June 2019) "The new left economics: how a network of thinkers is redefining capitalism", reviews how the discipline of economics is being redefined. Full article available at https://www.theguardian.com/news/2019/jun/25/the-new-left-economics-how-a-network-of-thinkers-is-transforming-capitalism

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## POLICY OPTIONS FOR SMALL COUNTRIES

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The decision by the Trump administration to withdraw from the Iran deal and to amplify its sanctions regime against Iran has demonstrated how a relatively unused and untested tool available uniquely to the US: the dollar as a currency, together with the infrastructure of the global payments system, is being weaponised.


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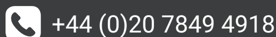
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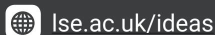
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